Supplemental compensation for closely held businesses

Choosing between bonus plans and nonqualified deferred compensation plans

To find the most appropriate executive-compensation package for meeting your long-term financial objectives, consider the following two widely used compensation strategies.

In an executive bonus plan, you provide bonus compensation on top of an employee's base salary. Executive bonus plans can be structured either as a cash bonus that an employee may spend immediately or as a restricted bonus that the employee agrees in writing that he or she will not use the investment as collateral for a loan or take cash withdrawals from the investment until the employee reaches a certain age (e.g., age 60), retires, or separates from service. Restricted bonus arrangements can call for investments in life insurance or annuity contracts, or in other non-tax deferred vehicles such as mutual funds.

The bonus is taxable immediately to the executive receiving the bonus and is immediately deductible to the business. Many executives get both cash bonuses and restricted bonuses.

What is a nonqualified deferred compensation plan?

A nonqualified deferred compensation (NQDC) plan is your unsecured promise to provide compensation to an employee at some future time. Both for-profit and not-for-profit employers can implement NQDC plans.*

Unlike a qualified retirement plan covering all employees, you may offer an NQDC plan to only a select group of highly compensated or management employees. You will typically purchase taxable or tax-deferred investments to provide the funds to meet your obligations for future payment. These investments are assets of the business and subject to the claims of its general creditors.

NQDC plans can be based on your contributions, employee salary deferrals or a combination of both, letting the employee defer current taxation on earned income. You may give an employee a vested right to the benefits or may subject the benefits to forfeiture provisions. An NQDC plan can also be designed for a gradual vesting of benefits based upon an employee's years of service (e.g., 10% of benefits vest each year the employee remains with the business), or by using a vesting schedule requiring employees to forfeit any benefits if they separate from service before a set retirement age (e.g., age 60) or a period of years. Vesting periods for NQDC plans can be longer and more restrictive than those allowed for qualified plans, so you can use an NQDC plan as "golden handcuffs."

How do tax laws affect NQDC plans?

Eligible employees are generally required to elect to make salary deferrals before the start of an NQDC plan's calendar year or within 30 days from the date eligibility begins. Participant withdrawals from the plan are limited to death, disability, separation from service, a specified future date, change in employer ownership control, or unforeseen hardship. Tax-law changes have restricted accelerated plan distributions both during employment or after separation from service. They also require tax reporting by employers for employee deferrals and employer-vested contributions on Forms W-2 or 1099, depending on employee status. If the NQDC plan fails to comply with these requirements, participants must pay tax on the affected amount, plus interest, at the IRS underpayment rate plus 1%, with an additional 20% tax penalty.

*Tax rules for not-for-profit employers are considerably different and are not discussed in this report.

Limitations of NQDC plans

Nonqualified deferred compensation is generally not an effective tax strategy for owners of pass-through businesses such as S corporations, partnerships, or sole proprietorships. Since contributions to an NQDC plan are not deductible, these owners do not defer receipt of their income. In these types of businesses, you may want to consider using tax-advantaged investments such as Roth IRAs, life insurance, annuities, or municipal bonds if you are at your personal limit in making qualified plan contributions.

Bonus and NQDC plans comparison

	Bonus plan	NQDC plan
Is a written plan document required?	No, but often recommended	Yes
Can employer discriminate as to employee participation?	Yes	Yes
Are there costs for plan administration and tax reporting?	No	Yes
Are employer contributions an immediate tax-deductible business expense?	Yes	No
Are employer contributions to employee immediately taxable to employee?	Yes	No
Are there rigid IRS rules for plan contributions and distributions?	No	Yes
Are employee salary deferrals exempt from current taxation?	Not applicable	Yes
Is there a minimum compensation required for employee participation?	No	Facts and circumstances test
Are plan assets subject to claims of the employer's creditors?	No	Yes
Does plan create "golden handcuffs?"	No	Yes
Can plan assets grow tax-deferred?	Yes, depending on investments chosen	Yes, depending on investments chosen
Can employer receive cost recovery	No	Yes, if life insurance is owned on employees
Can business owner participate?	Yes	Yes (may not be tax advantageous for S corporations, partnerships and LLCs)